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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM 1929.

No. 314.

NILES BEMENT POND COMPANY, *Petitioner*,

vs.

THE UNITED STATES, *Respondent*.

BRIEF OF PETITIONER.

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BRIEF OF PETITIONER.

I.

THE OPINION OF THE COURT BELOW.

The opinion in the Court of Claims is not yet reported. The opinion was rendered by the Court of Claims May 13, 1929, (R. 27).

II.

STATEMENT OF THE CASE.

This suit was instituted in the Court of Claims to recover corporate income and profits taxes for 1918

alleged to have been erroneously and illegally collected by respondent from petitioner. The Court of Claims dismissed the petition and rendered judgment against the petitioner (R. 40). Petition for certiorari was granted October 21, 1929.

The question here presented is:

Whether petitioner was entitled in 1918 to a credit under Section 238 (a) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1080) for certain British income taxes and excess profits duties paid during 1918, where the first information received by petitioner as to the amount of such taxes so payable was received in 1918 and the taxes were first entered upon petitioner's books during 1918 as an expense for that year in accordance with the method of accounting regularly employed by petitioner in keeping its books.

The only portions of the pleadings, findings and opinion relating to this question (one of three separate claims originally presented, the other two having been abandoned) are: amended petition, paragraphs 8 to 13 (R. 13-19); and paragraphs 20-25 (R. 25-26); findings of fact Nos. I-XI, inclusive (R. 27-30); and that part of the opinion beginning on page 37 and concluding at the end of the first paragraph on page 39 of the Record.

The findings of fact upon the question here presented (Nos. V to XI, inclusive), show (R. 28-30):

During the year 1918 petitioner paid to the Government of Great Britain an income tax for the year ending April 5, 1918, and also an excess profits duty for the accounting period ended December 31, 1916 (R. 28). These taxes were paid pursuant to notices, one dated January 24, 1918, and the other dated January 19, 1918, which notices were the first notice, assessment,

demand or information received by petitioner as to the amount of the taxes so payable (R. 28). Under the method of accounting regularly employed by petitioner in keeping its books throughout the year 1918, the accounting for expenses of its London Office was on a cash disbursements basis and no accruals were made for any such expenses in advance of their payment (R. 29). The British taxes paid in 1918 were expenses of petitioner's London Office and were entered on the petitioner's books of account at the time of payment in 1918 in accordance with the method of accounting regularly employed in keeping petitioner's books (R. 29). Except for expenses of the London Office and some additional small items where the cash basis was reflected, petitioner's books were kept on the accrual basis and the principal and dominant purpose and plan of its accounts were to show income upon an accrual basis as the general and controlling character of the accounts (R. 29-30).

Petitioner took the credit in 1918. The Commissioner of Internal Revenue disallowed the credit thus taken, thereby increasing the tax payable for that year. The tax was paid by petitioner and suit was filed by it in the Court of Claims for recovery. The Court of Claims held that credit was not properly taken in 1918 and dismissed the petition.

It is not disputed that these taxes and duties were of the character allowable as a credit under Section 238 (a) of the Revenue Act of 1918. The question is whether credit may be taken (and the statutory provisions are the same as to the deduction of expenses) in the year of payment, when the method of accounting regularly employed calls for entry in the books of account on a cash disbursements basis, the majority

of the taxpayer's accounts being upon an accrual basis but a considerable section of such accounts, as in this case all the London Office expense accounts of this petitioner, being on a cash basis.

III.

SPECIFICATION OF ERRORS.

1. The Court of Claims erred in holding that the statutory phrase "method of accounting regularly employed in keeping the books of such taxpayer," describes only two systems of accounts, one a "strict cash basis" and the other a "strict accrual basis".

2. The Court of Claims erred in holding, in effect, that books must be kept and income returned upon either a strict cash basis or a strict accrual basis.

3. The Court of Claims erred in holding that petitioner was not entitled to a credit in 1918 for British taxes under Section 238 (a) of the Revenue Act of 1918, although it found as facts that such taxes were paid in 1918, and were entered on petitioner's books of account at the time of payment in 1918 in accordance with the method of accounting regularly employed in keeping such books.

4. The Court of Claims erred in considering as material the fact that accounts other than the London Office accounts to which the British taxes belonged, were kept on the "accrual basis," and in holding that under a method of accounting upon a mixed accrual and cash disbursements basis a credit was allowable according to the basis of the majority of the accounts regardless of the basis of the particular account in which the expenditure belonged.

5. The Court of Claims erred in denying to petitioner its claim for credit for British taxes paid in 1918.

6. The Court of Claims erred in dismissing the petition and in entering judgment for the defendant.

IV.

SUMMARY OF ARGUMENT.

The case turns upon the meaning of the phrase "method of accounting regularly employed in keeping the books of such taxpayer", as it appears in section 212 (b) of the Revenue Act of 1918.

This phrase was first adopted in the Revenue Act of 1918 which for the first time required returns on the basis of the method of accounting employed, the statutes theretofore having required returns on the cash receipts and disbursements basis, although under the 1916 Act corporations were accorded the option of reporting upon the basis upon which its accounts were kept. The statutory history shows that Congress deliberately refrained from prescribing any inflexible method of accounting and the Act clearly expresses the intent of Congress to make the books of account, as kept in accordance with the method of accounting regularly employed, the basis for return of income.

This Court has not decided the rule applicable under mixed systems of accounting such as the one in this case, but in several decisions relating to this subject, under both the 1918 and 1916 Acts, has held the taxpayer's method of accounting controlling in determining whether deductions and credits should be taken when paid or when accrued.

The Court of Claims held that the phrase includes only two systems of bookkeeping, one a strict cash basis and the other a strict accrual basis, and that all deductions and credits must be made according to the

predominant purpose of the account. This, we insist, was erroneous because it ignores the phraseology of the statute; it conflicts with the contemporaneous departmental construction of the statute; and it conflicts with principles announced by this Court in several decisions.

The lower court's decision cannot be supported on the ground that petitioner's method of accounting did not clearly reflect income. No such objection was ever advanced in the lower court or at any other time during the progress of this case before the Bureau of Internal Revenue and it is too late to raise such an objection for the first time in this Court. If the point be considered, it is plainly without merit, because there has been no finding by the Commissioner that petitioner's method of accounting did not clearly reflect income; none of the numerous adjustments necessary if petitioner's method had required changing, have been made; and the record clearly shows that petitioner's method of accounting, as a method, was accepted by the Commissioner. Mixed accounting methods are frequently necessary to meet special requirements of a business and they are commonly used. In plaintiff's method of accounting each group of accounts had a definite basis and the basis for each class of accounts was uniformly and consistently applied. It cannot be successfully charged that such an accounting method failed clearly to reflect income.

Where, as in this case, the accounts, generally speaking are on an accrual basis but certain sets of accounts, due to some compelling peculiar condition, such as the operation of this petitioner's London Office, are upon a cash basis, items entered on the books on a cash basis, in accordance with that method, should be

deducted or credited on income tax returns in the year when they are paid.

V.

ARGUMENT.

A. The Statute.

Section 238 (a) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1080) under which petitioner claims credit for certain British income taxes and excess profits duties paid during 1918, provides:

> Section 238 (a). "That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by Title III shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States."

The petitioner's case depends upon the construction of the statutory provisions defining the term "paid," which provisions in the Revenue Act of 1918 are as follows:

> Sec. 200. "The term 'paid' for the purposes of the deductions and credits under this title, means 'paid or accrued', or 'paid or incurred', and the terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212."

> Sec. 212 (b). "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as

> the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income * * *."

The two sections above quoted may be summarized as follows:

> "The term 'paid' * * * means 'paid or accrued' or 'paid or incurred' * * * (which terms) shall be construed according to the method of accounting upon the basis of which the net income is computed * * *. The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers."

Further abbreviating, the statute requires that the terms "paid or accrued" and "paid or incurred" shall be construed according to the method of accounting regularly employed in keeping the taxpayer's books.

The Sections of the statute above quoted are from the Revenue Act of 1918. Similar provisions employing the phrase "method of accounting regularly employed in keeping the books of such taxpayer" are contained in all subsequent revenue acts, including the statute now in force. (Secs. 200 and 212 of the Revenue Act of 1921, c. 136, 42 Stat. 227; Sections 200 and 212 of the Revenue Act of 1924, c. 234, 43 Stat. 253; Sections 200 and 212 of the Revenue Act of 1926, c. 27, 44 Stat. 9; and Sections 41 and 43 of the Revenue Act of 1928, c. 852, 45 Stat. 795).

B. The Statutory History.

The Revenue Act of 1909 (c. 6, Sec. 38, 36 Stat. 11, 112) required that income should be returned on a cash receipts and disbursements basis and its terms did not permit the accrual of either income or expense items, regardless of the basis on which the books of account of a taxpayer might be kept. The Revenue Act of 1913 (c. 16, Sec. 11, Sub-division G, 38 Stat. 114, 172) continued this requirement of a return on a cash receipts and disbursements basis regardless of the method of accounting which might be used by the taxpayer.

The Revenue Act of 1916 (c. 63, 39 Stat. 756) continued the provision for a return on a cash receipts and disbursements basis (Sec. 12 (a)) but introduced an alternative provision (Sec. 13 (d), appendix p. 31) permitting a corporation "keeping accounts upon any basis other than that of actual receipts and disbursements", to make its return "upon the basis upon which its accounts are kept."

The Revenue Act of 1917 (c. 63, 40 Stat. 300) made no change in these provisions and the Revenue Act of 1916 remained in force and unamended in these respects.

Thus prior to the Revenue Act of 1918, Congress, after having required the cash basis as the sole basis for making returns of income under the first two Revenue Acts, modified that requirement by permitting (for corporations but not for individuals) in the 1916 Act a return on the basis upon which the accounts were kept when that basis was other than actual receipts and disbursements.

The Revenue Act of 1918 took the remaining step toward a complete reversal of the earlier requirements

and not only permitted returns on a basis other than actual receipts and disbursements but required (for both corporations and individuals) that the returns be made on the basis of and in accordance with the method of accounting regularly employed in keeping the books of the taxpayer.

Section 13 (d) of the 1916 Act did not use the word "accrual" or any similar term but allowed the return "upon the basis upon which its accounts are kept", phraseology which evidently contemplated varying systems or methods of accounting. Under authority of this provision of the statute, Treasury Decision 2433 (Appendix p. 31) was promulgated January 8, 1917, prescribing regulations governing returns made on other than a cash receipts and disbursements basis. In that Treasury Decision, the terms "accrual", "reserves" and similar terms were used and the Department has contended that under that Treasury Decision a taxpayer was required either to make its return upon the strict cash receipts and disbursements basis or upon such accrual basis as the Commissioner might require. In framing the 1918 Act, Congress did not adopt the phraseology of the Treasury Decision but used the phrase "method of accounting regularly employed in keeping the books of such taxpayer." This phraseology, like that of the 1916 Act, obviously contemplated different and varying methods of accounting adaptable to the peculiar requirements of each taxpayer's business. This view was recognized in the regulations first issued under the 1918 Act and in regulations issued under subsequent Acts containing like phraseology.

The 1918 Act, in the form in which it first passed the House, (H. R. 12863, 65th Congress, 2nd Session) did

not contain any definition of the word "paid" or of the terms "paid or incurred" or "paid or accrued". It did contain Section 212 (b) substantially in its final form providing for the computation of net income in accordance with the method of accounting regularly employed in keeping the books. The Senate added the provision in Section 200 defining the terms "paid or incurred" and "paid or accrued" and the conferees added the definition of the term "paid". (H. R. 12863, Committee Print, as agreed to in Conference, Volume 33, House of Representatives Bills, 65th Congress; Appendix p. 34.)

With respect to the conference amendment to Section 200, the Conference Report (House Report No. 1037, 65th Congress) stated (p. 44):

> "This amendment provides that the terms 'paid or incurred' and 'paid or accrued' when used in the income tax title shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and the House recedes with an amendment defining the word 'paid' when used for the purpose of computing the deductions and credits."

In stating the deductions to be allowed from gross income, both House and Senate had used the term "paid or incurred" in some cases (Secs. 214 (a) (1) and 234 (a) (1)) and in other cases both had used the term "paid or accrued". (Secs. 214 (a) (2) and (3) and 234 (a) (2) and (3)). With respect to allowable credits, only the term "paid" had been used in both House and Senate drafts of the bill. (Secs. 222 (a) (1) and (2) and 238 (a)). The conferees added to the provisions for foreign tax credits, both as to individuals (Sec. 222) and as to corporations (Sec. 238;

see Appendix. p. 34) a paragraph with respect to treatment of accrued foreign taxes. At the same time, the conferees added the definition of the term "paid", obviously for the purpose of making the same rules apply to credits as to deductions.

Neither the House nor Senate Committee reports (House Report No. 767 and Senate Report No. 617, 65th Congress) contained any discussion of the definitions of "paid" and like terms in Section 200 or of the basis of computing income prescribed in Section 212 (b). The amendments in both sections made by the Senate Finance Committee were agreed to by the Senate without debate (Congressional Record, 65th Congress, 3rd Session, pages 296 and 553).

Thus, the change from the requirement of the cash basis for all returns (with an option to corporations to make returns upon the basis upon which its accounts were kept) to the requirement that all returns must be upon the basis and in accordance with the method of accounting regularly employed, was accomplished without comment in the Committee reports, and so far as we can discover, without mention in the debates on the bill. The statutory history gives no reason for ascribing to Congress any intention other than that which the phraseology implies, namely, that the books of account, kept in accordance with an accounting method regularly employed, should be the controlling test in determining whether deductions or credits should be taken at the time of accrual or at the time of payment. Congress at all times, in the 1918 and prior Revenue Acts, deliberately refrained from prescribing any method of accounting but allowed taxpayers full freedom in devising their own books and forms and in adapting their own methods of account-

ing to the particular needs of their respective business organizations. It seems clear that it was the intent of Congress to make the books of account, as kept in accordance with a method of accounting regularly employed, the basis for return of income rather than any arbitrary basis which would necessitate numerous, and often complex, adjustments between the books of account and the return.

C. Review of Cases Construing These Statutory Provisions.

These provisions of the 1916 and 1918 Acts have been before the Court in several cases. It has been decided that the statute requires the deduction or credit to be taken in the year of accrual when the method of accounting is on an accrual basis and the book entries in question are made as accruals or should be so made under the method of accounting regularly employed. *United States v. Anderson,* and *United States vs. Yale & Towne Company,* 269 U. S. 422, reversing *Anderson v. United States,* 60 Ct. Cls. 106, and *Yale & Towne v. United States,* 60 Ct. Cls. 440; *American National Company vs. United States,* 274 U. S. 99.

It has been decided that the statute requires the deduction or credit to be taken in the year of payment when the method of accounting is on a cash receipts and disbursements basis and the book entries in question are made as cash transactions or should be so made under the method of accounting regularly employed. *United States v. Mitchell,* 271 U. S. 9, reversing *Mitchell vs. United States,* 60 Ct. Cls. 451.

When the method of accounting is on a mixed accrual and cash disbursements basis, containing groups of accounts on the cash basis but a majority of the ac-

counts on an accrual basis, and when the book entries in question are and should be on the cash basis under the method of accounting regularly employed, it has not been decided whether the deductions and credits should be taken in the year of payment in accordance with the basis of the particular accounts to which the expenditure belongs under the method of accounting regularly employed, or in the year of accrual in accordance with the basis of the majority of the accounts but contrary to the basis prescribed by the method of accounting regularly employed. That question is presented in this case.

We emphasize that in this case the British tax payments were not isolated items in a set of accounts on the accrual basis but were a part of the London Office expense accounts, all of which were on a cash disbursements basis under the method of accounting regularly employed by the petitioner (R. 29, findings IX and X).

This Court in deciding cases of this character has laid much emphasis upon the method of accounting employed by the taxpayer, and in all of its decisions has held the particular method of accounting actually employed to be controlling in determining whether deductions shall be taken when paid or when accrued.

In *United States vs. Anderson and United States vs. Yale & Towne Company,* 269 U. S. 422, which dealt with the deduction of munitions taxes in making a return under the Revenue Acts of 1916 and 1917, the decision was based upon the method of accounting regularly employed by the taxpayers. In both cases it appeared that the munitions taxes in question had been accrued on the books of the taxpayers in 1916 in accordance with the method of accounting regularly employed. In the *Anderson case* a reversing entry was

made at the close of the year, closing out the reserve for munitions taxes accrued (269 U. S. 422, 442, 443), but it was clear that the method of accounting regularly employed required the accrual of such items and therefore the reversing entry was disregarded. In the opinion, the Court said:

> "It should be noted that Sec. 13(d) makes no use of the words 'accrue' or 'accrual' *but merely provides for a return upon the basis upon which the taxpayer's accounts are kept,* if it reflects income—which is precisely the return insisted upon by the Government. We do not think that the Treasury decision contemplated a return on any other basis when it used the terms 'accrued' and 'accrual' and provided for the deduction by the taxpayer of items 'accrued on their books.' " (269 U. S. 422, 441, italics ours.)

In *American National Company* vs. *United States,* 274 U. S. 99, the particular method of accounting regularly employed by the taxpayer was held controlling and the return made in accordance with the actual book entries under that method was upheld against the Government's contention that the accruals shown on the books had not in fact accrued and that the method of accounting employed did not correctly reflect income.

A similar question under the Revenue Act of 1916 was presented in *Reinecke* vs. *Gardiner,* 277 U. S. 239, on certificate from the Circuit Court of Appeals of the Seventh Circuit, but the Court declined to pass on the question because the certificate failed to show the basis upon which the return was made. The Court said:

> "We are unable to answer the question for the reason that the certificate omits to state facts essential to its determination. The applicable section, 13(d) of the Act of 1916, directs that if the taxpayer keeps his books on any basis other than that of actual receipts and disbursements, and the return is made on the basis adopted, the tax shall be computed on that basis unless the books clearly do not reflect the taxpayer's true income. In *United States* vs. *Anderson*, 269 U. S. 422, it was pointed out that under the Act of 1916 and applicable treasury regulations, the taxpayer must make all deductions from gross income as of the year when the payments were made unless he keeps his books on an accrual basis which accurately reflects his income, and actually made his return on that basis. See *United States* vs. *Mitchell*, 271 U. S. 9; *American National Co.* v. *United States*, 274 U. S. 99. The present certificate fails to state whether the books of the trustee as kept reflected his income or whether his return was made on the accrual basis or on the basis of actual receipts and disbursements." (277 U. S. 239, 244-245.)

In *United States* vs. *Mitchell*, 271 U. S. 9, arising under the Revenue Act of 1918, it was held that when the method of accounting was on a cash basis, an estate tax was deductible from income in the year when paid and not in the year when accrued. The Court there said:

> "The return shows that it was made on the basis of income actually received in 1919. This indicates that the accounts were kept on the basis of actual receipts and disbursements, and there is nothing in the record to show that any other method was employed. The burden is on the executors to establish the invalidity of the tax. *United States v. Anderson, supra.* They have

not shown that their books were kept on the accrual basis. Assuming, as we must, that the accounts of the estate were kept on the basis of actual receipts and disbursements, the executors were required to make return on that basis." (271 U. S. 9, 12.)

The Court again considered the same question in denying certiorari in *Fourth & Central Trust Company, Executor* vs. *United States,* 278 U. S. 604. It there appeared that the taxpayer's books did not disclose any accrual of the estate tax or any entry until paid in the year after accrual and it was accordingly held that the deduction must be taken when paid and not when accrued. (*Fourth & Central Trust Company, Executor* vs. *United States,* 65 Ct. Cls. 96, 98-99, 100.)

D. The Statute Has Been Erroneously Construed and Applied by the Lower Court.

The Court of Claims applied the above quoted provisions of the statute to this case as follows:

"The right to recover depends in this instance upon whether the plaintiff kept its books on an accrual or cash basis. An examination of its books and its system of accounts by the Commissioner of Internal Revenue satisfied that official that they were kept on an accrual basis within the meaning of the statute, and he so ruled. It is admitted that no system of bookkeeping will probably be found which is on a 100% accrual basis. In almost every case where books are kept on an accrual basis, as a general principle of business, there are instances where certain accounts, small and sometimes covering a small percentage, are kept on a cash basis. We there-

fore concur in the ruling of the Commissioner that the books were kept on an accrual basis.

"The Court has found that while it appears that some of the accounts of the plaintiff were kept upon a cash basis *and the British account among them*, it does not clearly appear what proportion was kept on the accrual basis, or that the greater proportion of its business was not kept upon the accrual basis * * *.

"* * * Where only a relatively small part has been on the cash basis it must be held that the income should have been returned upon an accrual basis." (Italics ours.) (R. 38-39.)

We submit the Court of Claims erred in this construction of the statute.

1. The lower court's construction ignores the phraseology of the statute.

The statute makes the test "the method of accounting regularly employed in keeping the books of such taxpayer." The terms are simple and plain. Only one qualification appears in that section and that is that the method employed must clearly reflect income, which qualification we shall later discuss. Otherwise the taxpayer's method of accounting governs and the statute does not authorize the application of any other test or rule for determining whether an expenditure shall enter into the return of income at the time of accrual or not until the time of payment.

The statute does not require that income shall be returned upon a cash basis or upon an accrual basis or upon the basis upon which the majority of the accounts may be kept. The statute uses neither the term "cash" nor the term "accrual." It requires only that the return of income shall be in accordance

with the method of accounting regularly employed in keeping the books of such taxpayer. The language of the statute plainly negatives the construction placed thereon by the Court of Claims.

The Court of Claims does not cite or quote the particular language of the statute upon which its conclusion is based. The Court held in effect that books must be kept and income returned upon either a strict cash basis or upon a strict accrual basis. But neither of these terms is used in the statute and nowhere is there any definition of or limitation upon the method of accounting which may be used by a taxpayer, other than the qualification above referred to, that it must clearly reflect income.

The lower court in its opinion also stated that the books of petitioner were kept on an accrual basis "within the meaning of the statute." It mistakenly assumed the presence in the statute of the term "accrual" or of some definition of the accrual basis of accounting. Neither such a term nor such a definition are found anywhere in the statute.

The opinion of the Court of Claims also shows that it considered as material the basis upon which the majority of the accounts were kept or upon which the greater proportion of the business was entered on the books. The Court evidently was of the opinion that in a mixed accounting method, partly accrual and partly cash disbursements basis, the test should be the basis of a majority of the accounts or the basis of the accounts containing the greater proportion of the business transacted. The language of the statute contains no warrant whatever for any such test.

It seems obvious that the lower court has overlooked and failed to give effect to the phraseology of the statute. It found that the British taxes were

entered on the petitioner's books of account at the time of payment in 1918 "in accordance with the method of accounting regularly employed in keeping plaintiff's books." This finding is almost in the language of the statute and shows conclusively that the particular entry of British taxes in 1918 fully met the requirements of the statute to make the entry properly allocable to that year in the return of income for tax purposes. The subsequent finding that other accounts were kept on the accrual basis and that the principal and dominant purpose and plan of the accounts were to show income upon an accrual basis as a general and controlling character of the accounts, cannot affect the answer to the question here presented. The test prescribed by the statute is the method of accounting regularly employed. That must necessarily mean the basis of the particular account to which the entry in question belongs under the method of accounting regularly employed and not the basis of some other account or of the majority of the accounts. The findings of fact unqualifiedly show that the British taxes were expenses of petitioner's London office; that under the method of accounting regularly employed, expenses of the London office were on a cash basis; and that the British taxes in question were entered in 1918 on the cash basis in accordance with the method of accounting regularly employed. On these facts, the statute requires that the British taxes enter into the accounts for tax purposes at the time of payment and not at any other time.

2. The lower court's construction conflicts with contemporaneous departmental construction.

The language of the statute obviously contemplated a variety of accounting methods differing with the special requirements of each taxpayer. The regulations of the Treasury Department ever since those first promulgated under the Revenue Act of 1918 consistently so recognized. Neither the statute nor the regulations undertook to prescribe any particular method of accounting to the exclusion of all other methods. Neither attempted to limit taxpayers to a choice of alternative methods, either a strict cash basis or a strict accrual basis.

Regulations No. 45, as first promulgated under the 1918 Act, contained as part of Article 24 the following opening sentence, under the heading "Methods of Accounting":

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose."

Exactly the same sentence is contained in the regulations issued under all subsequent Revenue Acts. (Acts of 1921, 1924, 1926 and 1928; Art. 24 of Regs. 62, 65 and 69 and Art. 323 of Regs. 74.)

This contemporaneous departmental construction, announced soon after the enactment of the Revenue Act of 1918 and consistently adhered to in the construction of similar provisions of all subsequent Revenue Acts, constitutes convincing proof of the error of the interpretation placed upon the statute by the Court of Claims in its decision of this case. *United States v. Hermanos*, 209 U. S. 337; *United States v. Boston & Maine R. R.*, 279 U. S. 732, 734-736.

The enactment of the same provisions in subsequent Revenue Acts after they had been so construed by administrative regulations, confirmed that construction as being in accordance with the intent of Congress. *National Lead Co. v. United States*, 252 U. S. 140.

3. The lower court's construction conflicts with principles announced in decisions of this court.

In all of the decisions of this Court dealing with the question of when deductions or credits shall be taken, the accounting method actually employed by the taxpayer has been held controlling in determining whether deductions or credits shall be taken when paid or when accrued. None of these cases are authority for the proposition stated herein by the Court of Claims that the basis of the majority of the accounts must govern and the basis actually employed in accordance with the regular accounting method must be ignored. Such a proposition is distinctly negatived by the opinions of this Court in the cases heretofore discussed (supra, p. 13) and by the fact that this Court has uniformly adopted as the test, the method of accounting actually employed in keeping the taxpayer's books.

In this case the findings of fact show that the entries in the accounts were made when paid in the year 1918 and that the entries so made were in accordance with the method of accounting regularly employed by the petitioner. On those facts, the principles announced by the decisions cited require that the petitioner's method of accounting govern and that the credits be taken in the year when paid, regardless of the time of accrual.

E. The Lower Court's Decision Cannot be Supported on Ground that Petitioner's Method of Accounting did not Clearly Reflect Income.

As has been shown, the rule contained in the statute is that the method of accounting regularly employed governs in determining whether deductions or credits shall be taken in the year of payment or in the year of accrual. That method of accounting cannot be ignored or modified except upon one condition, namely, that such method of accounting does not clearly reflect the income, in which event the Commissioner is authorized to make the computation upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

That condition has no application in this case. The Court of Claims did not rest its decision upon that provision of the statute and at no time in the progress of this case, either before the Bureau of Internal Revenue or before the Court of Claims, was there ever any contention that the petitioner's method of accounting did not clearly reflect income. Furthermore, this is a question of credit of foreign income taxes against domestic taxes and not a deduction of an expense from gross income and therefore the question of clearly reflecting income does not arise in this case.

The Government's brief in opposition to petition for certiorari suggests, for the first time since this suit was begun, that the Commissioner's disallowance of the credit claimed was an implied finding that the method of accounting employed by petitioner did not clearly reflect income. We think it is too late to raise that point for the first time in this Court.

If the point may be considered, it is plainly without merit.

In the first place, an implication or inference certainly should not be sufficient to condemn a method of accounting regularly employed by a taxpayer. To set aside such method surely must require a direct and unmistakable finding that the method employed does not clearly reflect income. A finding that one single item of many should be changed certainly does not constitute a finding or even a suggestion that the method of accounting employed is improper as a method. The controversy here arose in the first instance because of the Commissioner's erroneous views as to his powers to adjust accounts on a taxpayer's books, views that were carried over from the administration of T. D. 2433 under the 1916 Act. His finding with respect to the British tax credit here in question therefore did not constitute even an implication or an inference that the method of accounting employed did not clearly reflect income.

Secondly, if the method employed does not clearly reflect income, the Commissioner is authorized to prescribe the basis and manner of the computation of income. This necessitates the adjustment of all accounts and entries to the basis which may be prescribed by the Commissioner. If the Commissioner prescribes a basis differing from the method employed he should be required to apply that basis consistently, and should not be permitted to make only isolated changes here and there with the sole object of increasing the tax. At least the taxpayer is entitled to notice of the basis which the Commissioner prescribes and opportunity to propose adjustments which will bring its accounts to the basis so prescribed. The object should be to so readjust the accounts as to clearly reflect income on the basis prescribed by the Commissioner. Here all of the London office expenses were on a cash basis.

The item of British taxes was but one of many London office expenses, which also included rent, salaries, commissions, property taxes, exchange, postage, and all other expenses of operating the London selling office. Had petitioner's method of accounting been rejected as not clearly reflecting income, numerous other adjustments would have been necessary in petitioner's London office accounts. Such adjustments were not made nor were they ever proposed by the Commissioner of Internal Revenue or by any other Government officer, nor was any opportunity ever given the taxpayer to make such adjustments.

Furthermore, the record clearly shows that the method of handling the British taxes, as a method, was accepted by the Commissioner of Internal Revenue for all other years (R. 29). For the year 1919, the year subsequent to that here involved, the British income tax was again paid, this payment being tax for the year following the year covered by the payments made in 1918. The payment made in 1919 was claimed as a credit in that year and was allowed as such credit (R. 29). The next year's British income tax, namely, for the year ending April 5, 1920, was not paid until 1924, due to numerous delays in the audit and final adjustment of the accounts with the British tax authorities. Had that tax been accrued in the manner in which the Government contends the tax payments of 1918 should have been accrued, it would have been allowable as a credit against the taxes for 1919. However, it was not so allowed. It remained in petitioner's accounts for 1924 and the only reason it was not claimed or allowed as a credit in that year was the fact that petitioner's return for 1924 showed a net loss and, therefore, there was not any tax due against which credit could be claimed. (R. 29.)

All payments of British taxes, other than the two payments made in 1918, were accepted and allowed by the Government as they appeared in petitioner's accounts and in accordance with the method of accounting employed by petitioner. Thus it is clear that the method of accounting, as a method of handling the British taxes, was affirmatively approved by the Commissioner for all years subsequent to the year 1918. If there was anything wrong with the method, as a method, it would have been necessary to change it and make adjustments in all years and not in one year only. The method cannot be wrong in 1918 and right in all other years. The Commissioner's approval of the method in subsequent years and the failure to make any express finding that petitioner's method of accounting employed in 1918 failed to clearly reflect income, show conclusively that the method was a proper one, that it did clearly reflect income and that there is no merit in the suggestion now made that the Commissioner's act should be sustained on the ground that the method of accounting employed by petitioner did not clearly reflect income.

It is not our position that an entry in the books of account is controlling if that entry is contrary to the accounting system and not the kind of entry that the method of accounting regularly employed requires. But if the entry is in accordance with the method of accounting regularly employed, and in this case the findings of fact so show (R. 29), the statute requires that the actual entry must be given effect and the deduction or credit of that item must be determined in accordance with the entry.

The situation here presented is not that of an isolated entry on a cash basis in an accounting system on a strict accrual basis. Here a separate and distinct

group of accounts, those pertaining to the London office of petitioner, were regularly on a cash basis. The principal accounts in the United States were on an accrual basis; some of the minor domestic accounts were also on a cash basis.

It cannot be said that such a method of accounting fails to clearly reflect income. Petitioner had a definite and well formulated method of accounting devised to meet the requirements of its business.

The cash basis was adopted for the London office expenses for reasons of convenience and necessity. The evidence in the lower court went into great detail in describing the method of accounting employed in the London office, and the system of vouchers of cash disbursements periodically transmitted from the London office to the main office in New York. The original book records and vouchers containing all entries of 1918 pertaining to the London office accounts were before the court. From that evidence the lower court made the finding that the accounting of expenses of the London office was on a cash disbursements basis and that the British tax payments in question were expenses of the London office and were entered in 1918 in accordance with the method of accounting regularly employed (R. 29).

Mixed accounting systems such as that of petitioner are in common use by corporations and other business organizations. As stated in the lower court's opinion:

> "It is admitted that no system of bookkeeping will probably be found which is on a 100 per cent accrual basis. In almost every case where books are kept on an accrual basis, as a general principle of business, there are instances where certain

accounts, small and some times covering a small percentage, are kept on a cash basis."

It is equally true that frequently certain groups of accounts, which must be kept in part away from the main accounting office, are kept on a cash basis while the main accounts are on an accrual basis. In petitioner's case it would have given rise to many complications and considerable expense if accrual accounts had been kept for the London office and other foreign selling offices. It would have been necessary to have at each office bookkeeping departments and the complications of foreign exchange would have made the handling of accruals difficult and burdensome. Elaborate accounting systems for distant foreign offices, which were only selling offices, were wholly unnecessary and would have resulted in making the accounting a burden to the business rather than an aid to it. These and other reasons caused petitioner to adopt the accounting system which it regularly employed in the handling of foreign office expenses.

It cannot be charged that the entry of British tax payments at the time of payment was prompted by the desire to have them allowed as a credit against taxes for the year 1918. These payments were made and entered on the books in January, 1918, and the Revenue Act, which for the first time allowed as a credit payments of foreign taxes and which for the first time adopted the test of the method of accounting as the test for determining whether items should enter into the tax returns in the period of accrual or the period of payment, was not enacted until February 24, 1919, more than one year after these payments had been made and entered on the books. The bill had not even been drafted when the British tax payments were made

and entered on the books. It cannot therefore be suggested that petitioner's method of accounting was devised or modified to meet the provisions of this statute.

F. Conclusion.

The correct construction of the statute is that the terms "paid or incurred" and "paid or accrued," wherever used in the Act, mean *paid* for all items which under the taxpayer's method of accounting are regularly entered on the cash disbursements basis; that they mean *incurred* or *accrued* for all items which, under the taxpayer's method of accounting, are regularly entered on the accrual basis. Entries in the books of account made in accordance with the method of accounting regularly employed must govern, so long as it is not found that the accounts thus kept do not reflect accurately the income. Applying the rule to this case, the term "paid" in section 238 (a) of the Revenue Act of 1918 means "paid" and not "accrued" in relation to the British taxes here in question, for those British tax payments were entered on petitioner's books on the cash disbursements basis in accordance with the method of accounting regularly employed. The foreign tax payments, paid in 1918, are therefore allowable as a credit for that year.

It is therefore respectfully submitted that the judgment of the lower court on the point here presented, namely the allowance of credit under section 238 (a) of the Revenue Act of 1918, against the income and profits taxes of petitioner for the year 1918, should be reversed and the cause remanded to the end that

judgment may be awarded petitioner for refund of taxes due it upon the allowance of such credit.

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Washington, D. C.
December 30, 1929.

APPENDIX.

Section 13 (d) of the Revenue Act of 1916.

(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

T. D. 2433.
Corporation Income Tax.

Corporations keeping books in accordance with standard systems of accounting or in conformity with the requirements of some Federal, State, or municipal authority having supervision over such corporations, may make their returns on the basis on which their books are kept, provided the books so kept and the returns so made reflect the true net income of the corporations for each year.

Treasury Department,
Office of Commissioner of Internal Revenue,
Washington, D. C., January 8, 1917.

To collectors of internal revenue:

Subparagraph (d) of section 13 of Title I of the Act of September 8, 1916, provides that—

A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval

of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the rea-

sonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad

debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:
W. G. MCADOO,
Secretary of the Treasury.

Sections of Revenue Act of 1918 as Agreed to in Conference Showing Amendments of Senate and of Conferees.

(Parts in Roman type indicate provisions of House Bill unchanged. Roman type struck through indicate parts stricken by Senate and omitted by conferees. Italics indicate additions by Senate and agreed to by conferees. Capitals indicate added by conferees.)

Section 200.

THE TERM "PAID," FOR THE PURPOSES OF THE DEDUCTIONS AND CREDITS UNDER THIS TITLE, MEANS "PAID OR ACCRUED" OR "PAID OR INCURRED," AND *the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis on which the net income is computed under Section 212.*

Section 212 (b).

"(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in

accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if ~~it~~ *the method employed* does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . ."

Section 238.

"CREDIT FOR FOREIGN TAXES.

(a) That in the case of a domestic corporation the total ~~income war profits and excess profits~~ taxes imposed for the taxable year ~~by Act of Congress~~ *by this Title and by Title III* shall be credited with the amount of any income, war profits and excess profits taxes paid during the taxable year to any foreign country ~~Porto Rico or the Philippine Islands~~ upon income derived from sources therein *or to any possession of the United States.*

IF ACCRUED TAXES WHEN PAID DIFFER FROM THE AMOUNTS CLAIMED AS CREDITS BY THE CORPORATION, OR IF ANY TAX PAID IS REFUNDED IN WHOLE OR IN PART, THE CORPORATION SHALL AT ONCE NOTIFY THE COMMISSIONER WHO SHALL REDETERMINE THE AMOUNT OF THE TAXES DUE UNDER THIS TITLE AND UNDER TITLE III FOR THE YEAR OR YEARS AFFECTED, AND THE AMOUNT OF TAXES DUE UPON SUCH REDETERMINATION, IF ANY, SHALL BE PAID BY THE CORPORATION UPON NOTICE AND DEMAND BY THE COLLECTOR, OR THE AMOUNT OF TAXES OVERPAID, IF ANY, SHALL BE CRED-

ITED OR REFUNDED TO THE CORPORATION IN ACCORDANCE WITH THE PROVISIONS OF SECTION 252. IN THE CASE OF SUCH A TAX ACCRUED BUT NOT PAID, THE COMMISSIONER AS A CONDITION PRECEDENT TO THE ALLOWANCE OF THIS CREDIT MAY REQUIRE THE CORPORATION TO GIVE A BOND WITH SURETIES SATISFACTORY TO AND TO BE APPROVED BY HIM IN SUCH PENAL SUM AS HE MAY REQUIRE, CONDITIONED FOR THE PAYMENT BY THE TAXPAYER OF ANY AMOUNT OF TAXES FOUND DUE UPON ANY SUCH REDETERMINATION; AND THE BOND HEREIN PRESCRIBED SHALL CONTAIN SUCH FURTHER CONDITIONS AS THE COMMISSIONER MAY REQUIRE.

(B) This credit shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income ~~received~~ *derived* from sources within such foreign ~~country, Porto Rico, or the Philippine Islands~~ *country or such possession of the United States*, as the case may be, and all other information necessary for the computation of such credit."